The Tariff is Back in Town

President Trump's inauguration on January 20th came with a flurry of executive orders, targeting a wide range of issues from immigration to energy policy. Despite an extremely active first day in office, there was a notable lack of action around tariff policies that were heavily emphasized on the campaign trail. Global markets were reminded that those threats are still active after Trump declared a national emergency under the International Emergency Economic Powers Act of 1977 (IEEPA) to impose tariffs on Canada, Mexico, and China in order to curb fentanyl and illegal immigration into the US. Given the erratic nature in which policy actions are communicated by the incoming administration, it's difficult to ascertain the true nature of these threats. In assessing the balance of risks, we explore the potential implications of a full implementation of these policies below.

On Friday, January 31st, President Donald Trump signed orders for levies of 25% on Mexico, 25% on Canadian non-energy goods, 10% on Canadian energy, and a 10% increase to tariffs on Chinese goods. The tariffs target the United States' three largest trading partners, comprising 43% of US imports and close to 5% of GDP, using data from 2023. These actions, if fully implemented, would be materially larger than the tariffs implemented during Trump's first term and have significant impacts on markets and global economic growth. At full proposal, the average US tariff rate would increase from about 3% to over 10% according to Bloomberg economists, dealing a systematic supply shock to the US given the interconnectedness of trade between the three nations. Negotiations are still developing and it's highly uncertain if these threats end up materializing. As of February 3rd, 2025, both Mexico and Canada have negotiated a one-month delay for the implementation of the levies. Retaliatory measures have been communicated, but the trade imbalance relative to GDP is far greater for Canada (14%) and Mexico (16%) than it is for the US (1.3% for Canada and 1.2% for Mexico). These trade imbalances and stronger relative US growth highlight that any negative impacts from a trade war would be disproportionately higher for Canada and Mexico than it would be for the US. While the impacts of tariffs and a reciprocal retaliation are uncertain, preliminary estimates are that a 0.7% increase to Core Personal Consumption Expenditures (PCE) near-term would be more than offset by a 1.2% drag on GDP growth longer term.[1] There is a chance that Trump is using strong trade threats to negotiate higher priority items such as immigration and illegal drug trafficking, but the recent headlines serve as a reminder that commentary from the President should not be taken lightly.

We expect markets will exhibit increased sensitivity to tariff headlines as the implications for growth, inflation, and Fed policy are extrapolated in an extremely dynamic environment. Trump 2.0 is unique in that there is historical precedent that can be used as a guidepost in navigating the next four years. Jerome Powell oversaw the Fed back in 2018 when Trump's first round of tariffs was being implemented. Higher inflation and growth now relative to the 2018 to 2019 period, however, puts the Fed in a more difficult spot currently. If tariffs were fully implemented to the extent they have been threatened, there would likely be a step change in price levels that would put continued upward pressure on inflation and keep the Fed Funds rate higher. Longer term, however, the potential negative growth implications from a trade war could pressure the Fed to cut rates. Commentary from Fed officials in 2019 highlights that the negative hit to growth from tariffs was viewed at that time as a greater risk than the shorter-term price increases:

"Trade tensions also are likely to weigh on inflation. While higher tariffs could lead to a short-lived increase in inflation, I see the more persistent effect of escalating trade tensions as disinflationary. Increases in tariffs have contributed to upward pressure on the foreign exchange value of the dollar as they slow global growth and amplify the degree of U.S. economic divergence."[2]

The Fed exhibited its intention on maintaining strong US economic growth with their surprise 50bp cut in September of 2024, followed by another 50bps through the end of last year to ease the extent of policy restraint, despite inflation running above their 2% target.

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[1] Josh Wingrove, Skylar Woodhouse, and Jennifer A Dlouhy. "Canada, Mexico Hit Back at Trump Tariffs, China Vows Action." Bloomberg.com, February 2, 2025.
[2] Kansas City Fed President Esther George, Meeting of the Federal Open Market Committee June 18–19, 2019.

Optimism around continued strength has shifted focus back to addressing inflation, putting the Fed in a difficult position if tariffs were to simultaneously raise prices and lower growth. The timing and extent of tariff implementation will likely dictate the Fed's path forward. If companies are able to absorb price increases while avoiding extensive layoffs, consumption can remain strong, and the Fed could remain on hold for an extensive period of time to ensure inflation remains anchored. If, however, there was a material hit to US growth as a result of a trade war, the Fed might be forced to ease policy further regardless of further progress on inflation.

Trump may be using aggressive tariff threats as a negotiation tactic in order to gain leverage to strike a border policy deal in his favor, but having an understanding of the potential implications of these threats is key to actively managing portfolios in this new environment. Markets have been wary of Trump's intentions to follow through on the threats made early in his second tenure, but there is an underlying unpredictability within his leadership that cannot be ignored. After all, he appears to be following through on campaign promises.

Let's keep talking!

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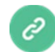

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